

***Shari'a* Compliant Finance: The Overlooked Element for Developing an Effective Financial System in Afghanistan**

**A Monograph
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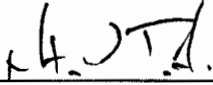
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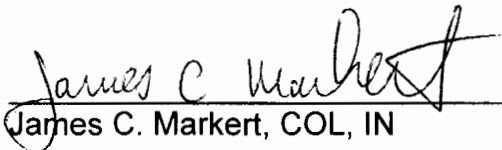
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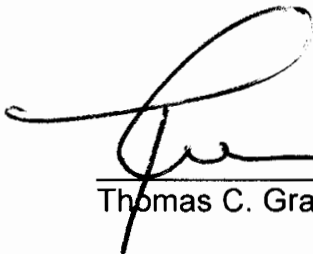
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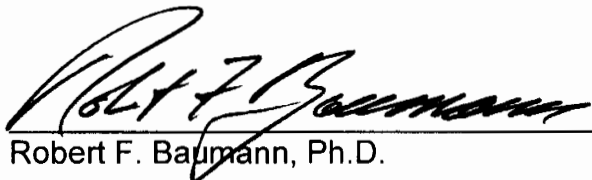
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Abstract

PREPARING A SAMS MONOGRAPH by LTC Jan Willem Maas, RNLA, 61 pages.

An effective financial system is essential to economic development. US Army doctrine acknowledges that military forces play an important role in supporting economic stabilization and infrastructure development. A specific task is to support the financial system. However, stability operations have not always been successful. First, Western stability operations have constrained economic development because the cultural paradigms of the Western actors and the local population have not fit. Second, segments of the Muslim community perceive Islamic banks as more reliable than other banks. Both reasons endanger the trust of Muslims in the financial system, which limits bank penetration and therefore hampers economic development.

This monograph argues that the application of *Shari'a* Compliant Finance (SCF) increases bank penetration and thereby improves economic development during stability operations in Afghanistan. Research found that Western organizations mainly used Western financial principles to develop the financial system in Afghanistan, while neglecting positive effects of SCF. The best way to apply SCF in order to improve the development of a financial system during stability operations is by facilitating local efforts that make use of religious reasoning and the social environment in order to gain and maintain subjective confidence. In order to mitigate the risk for sustainability of SCF on the longer term, international organizations like the World Bank and the IMF should maintain their focus on how to evolve a SCF system into a system that is still *Shari'a* compliant but also fulfills internationally recognized financial standards.

To support the development of a financial system successfully, commanders need to understand the implications of SCF. By appreciating and applying SCF, commanders can increase the trust of the population in their financial system resulting in increased bank penetration and economic development. This leads to five lessons for military commanders. The first lesson is that SCF is an alternative or at least a valuable complement for the development of a financial system in Afghanistan. The second lesson is that commanders should question and challenge the Western paradigm by a Muslim paradigm in order to prevent that the military commander develops a deficient operational approach. The third lesson is that the military has to invest in basic knowledge of the Afghan society, Islam, and SCF. The fourth lesson is that the military should start building partnerships with other organizations to enable unified action. The final lesson is that the military commander should focus on facilitating local efforts instead of providing a solution for the development of the financial system in order to achieve the maximum development results.

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Introduction

According to the President of the Kauffman Foundation, a country can only have peace and prosperity when its people truly own their economy.¹ US Army doctrine acknowledges that military forces play an important role in supporting economic stabilization and infrastructure development.² A specific task is to support strengthening the local economy. This includes support of the financial system.³ To be successful in supporting a financial system, commanders need a complete and thorough understanding of the operational environment.⁴ Because Islamic finance is part of an Islamic society, it is important that commanders understand the implications of *Shari'a* compliant finance (SCF), especially when supporting the financial system in an Islamic country like Afghanistan. Understanding SCF can help to establish confidence of Muslims in their financial system in order to increase bank penetration and thereby improve economic development. Bank penetration is the percentage of firms or people in a specific area that use banks or other financial institutions to fulfill financial services.

Until recently, the international community did not even consider Islam when developing the economy in Afghanistan. For example, in a report of the World Bank published in December

¹ Rebecca Patterson and Dane Stangler, *Building Expeditionary Economics: Understanding the Field and Setting forth a Research Agenda* (Kansas City, MO: Ewing Marion Kauffman Foundation, November 2010), 12.

² U.S. Army, *Field Manual 3-07, Stability Operations* (Washington, DC: Headquarters, Department of the Army, October 2008), 3-14–5.

³ *Ibid.*, 3-16.

⁴ U.S. Army, *Field Manual 3-0, Operations* (Washington, DC: Headquarters, Department of the Army, February 2011), 7-1.

2005 the World Bank assessed the investment climate in Afghanistan.⁵ The World Bank published the report four years after the start of the stabilization operation in Afghanistan.⁶ They acknowledged the importance of an effective financial system and even stated that access to finance was severely constrained for companies. However, not once did the World Bank refer to SCF.⁷ The negligence of SCF is probably one of the reasons why the World Bank and others developed in Afghanistan a financial system based solely on Western principles. Only in 2010 and 2011 did the Afghan legislature draft an Islamic banking law to enable SCF.⁸

The literature mentions two main reasons why the development of a Western financial system in an Islamic country is not successful. First, Western stability operations constrain economic development because Western development organizations and the local population have different cultural paradigms.⁹ This occurs because a segment of the Muslim population perceives conventional banks as un-Islamic because of the application of interest.¹⁰ In addition, conventional financial products do not fulfill the needs of the population because they are not

⁵ World Bank, *The Investment Climate in Afghanistan* (Washington, DC: The World Bank, December 2005), 1.

⁶ U.S. Department of State, "Background Note: Afghanistan," 6 December 2010, <http://www.state.gov/r/pa/ei/bgn/5380.htm> (accessed 9 February 2011).

⁷ World Bank, *The Investment Climate*, 1, 4, 13.

⁸ Shaheen Pasha, "Afghan Central Bank Sees Islamic Banking Law Enacted In 2011," *Reuters*, 6 February 2011, <http://www.reuters.com/article/2011/02/06/us-afghanistan-islamicbanking-idUSTRE7150EQ20110206> (accessed 4 August 2011).

⁹ Patterson and Stangler, *Building Expeditionary Economics*, 8–11.

¹⁰ Steven A. Zyck, "The Increasing Role and Potential of Islamic Finance in Afghanistan," Civil-Military Fusion Centre, March 2011, https://www.cimicweb.org/Documents/CFC_AFG_Economic_Stabilization_Archive/Contemporary_Economic_Issues_in_Afghanistan-Islamic_Finance-Mar_2011.pdf (accessed 6 August 2011), 1.

Shari'a compliant.¹¹ Second, a part of the Muslim community has no or very limited confidence in the imposed Western financial system because they believe that Islamic banks are more reliable and more stable than other banks.¹² This monograph defines this kind of confidence as subjective confidence, which means the way Muslims, individually or as a group, perceive their confidence in the financial system. This is different from objective confidence. There is objective confidence when banks fulfill the internationally recognized standards for financial institutions. The disconnect between the Western and Islamic paradigm and the perceived reliability of Islamic banks constrains bank penetration and therefore endangers economic development.

By neglecting SCF during planning and execution, stability operations do not take into account the presumed positive effects of SCF as an alternative to economic development. A Malaysian study showed a positive correlation between Islamic banking and economic development.¹³ According to other literature, the Islamic financial system facilitates economic development because it promotes socio-economic goals: applying SCF promotes social justice, equity, poverty alleviation, and human well-being. By achieving these goals, SCF copes with financial and social exclusion and, therefore, increases the number of people that can benefit from economic growth.¹⁴

¹¹ Nimrak Karim, Michael Tarazi, and Xavier Reille, "Islamic Microfinance: An Emerging Market Niche," *CGAP Focus Note* no. 47 (August 2008), <http://www.cgap.org/gm/document-1.9.5029/FN49.pdf> (accessed 6 August 2011), 5.

¹² Zyck, "The Increasing Role," 1.

¹³ Hafa Furqani and Ratna Mulyany, "Islamic Banking and Economic Growth: Empirical Evidence from Malaysia," *Journal of Economic Cooperation and Development* 30, no. 2 (2009): 70.

¹⁴ Salma Sairally, "Community Development Financial Institutions: Lessons in Social Banking for the Islamic Financial Industry," *Kyoto Bulletin of Islamic Area Studies* (2007), http://www.asafas.kyoto-u.ac.jp/kias/contents/pdf/kbl_2/05salma.pdf (accessed 4 August 2011), 19–20.

This monograph will argue that the application of SCF increases bank penetration and thereby improves economic development during stability operations in Afghanistan. Although some scientists claim that SCF products are only Islamic in form but not in content and SCF institutions have objective confidence shortcomings, the evidence will show that SCF improves subjective confidence and fulfills the needs of Muslims.

To substantiate this thesis, the monograph consists of five sections. The first section uses Afghanistan as a case study to determine the level of effectiveness of the Afghan financial system. The second section defines SCF and describes the sources, principles, products, and standards of SCF. The third section describes the possible ways SCF can facilitate the development of the formal financial system as claimed in predominantly Islamic literature. The fourth section applies elements of SCF to the financial system of Afghanistan. The fifth section describes the lessons military commanders at the operational level can learn when they support the development of a financial system in an Islamic society.

In order to conduct successful stability tasks, commanders must take into account that each country has its own unique characteristics that guide economic development.¹⁵ By understanding the implications of SCF, military efforts to support the development of a financial system can improve. Therefore, this monograph creates a nuanced and culturally sensitive solution, which will contribute to a successful result of a stability operation in an Islamic country such as Afghanistan.

¹⁵ Patterson and Stangler, *Building Expeditionary Economics*, 8.

Afghan Financial Development Results

This subsection reviews the development of the Afghan financial system as a contemporary example of developing a financial system during stability operations. This review shows that Western organizations developed the financial system in Afghanistan using mainly Western principles while neglecting the positive effects of SCF.

To provide a complete overview, this subsection will first describe the confidence necessary for the financial system to be effective. Second, this subsection will describe the major organizations and the ways in which they provided support for the development of the financial system. This subsection will conclude with the results of the development of the financial system in Afghanistan as assessed by the World Bank, as well as by the central Bank of Afghanistan, *Da Afghanistan Bank* (DAB). This provides an external and internal assessment of the Afghan financial system.

A financial system can only be effective if there is some degree of confidence in the financial system.¹⁶ However, confidence has both subjective and objective elements.¹⁷ It is subjective because it is up to the people to judge whether the system is reliable and whether they are willing to invest and deposit funds in the bank. If subjective confidence is low, people will avoid the formal financial system and local currency.¹⁸ On the other hand, confidence has an

¹⁶ Ake Lönnberg, "Restoring and Transforming Payments and Banking Systems in Post-Conflict Economies," Washington, DC: International Monetary Fund, May 2002, <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/lonnb.pdf> (accessed 24 November 2010), 3.

¹⁷ Keith Crane, Olga Oliker, Nora Bensahel, Derek Eaton, S. Jamie Gayton, Brooke Stearns Lawson, Jeffrey Martini, John L. Nasir, Sandra Reyna, Michelle Parker, Jerry M. Sollinger, and Kayla M. Williams, "Guidebook for supporting Economic Development in Stability Operations", *Technical Report*, RAND Cooperation, 2009, http://www.rand.org/pubs/technical_reports/2009/RAND_TR633.pdf (accessed 14 August 2011), 77–9.

¹⁸ Ibid., 77.

objective element that correlates to accountability according to internationally recognized standards. The World Bank emphasized the importance of accountability and transparency for a financial system.¹⁹ An effective financial system that satisfies both subjective and objective confidence helps to reduce risks and lowers the costs of financial transactions in order to facilitate sustainable economic development.

The first organization that supported Afghanistan was the World Bank. They provided technical assistance for the development of the infrastructure and the capacity of the DAB. The World Bank also provided assistance to implement changes in the financial sector. They assisted in improving human resource management, accounting and auditing, and in developing a system to supervise commercial banks according to international standards. An additional task was to improve credit risk assessments in order to reduce risk and increase credit based lending. Finally, the World Bank assisted the DAB and the Afghanistan Bank Association in the development of bankers training.²⁰ These programs focused on improving the efficiency and reliability of the banking system based on Western standards.

The second organization to offer support to Afghanistan was the International Monetary Fund (IMF). They provided assistance with currency reform, central bank modernization, and new financial and banking legislation.²¹ Additionally, an IMF staff team assisted the authorities in developing “a macroeconomic framework to guide economic decision-making” in order to

¹⁹ World Bank, *Financial Accountability in Nepal: A Country Assessment*. (Washington, DC: The World Bank, 2003), 107-110.

²⁰ The World Bank, *Financial Sector Strengthening Project*, 17 September 2008, http://www-wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/2008/09/17/000076092_20080918160815/Rendered/PDF/Project0Inform1cept0Stage0F0SEPT017.pdf (accessed 14 Augustus 2011), 4–7.

²¹ *Ibid.*, 8.

achieve sustainable economic growth.²² In 2003, the IMF prepared new banking and central bank laws, new payment laws, currency laws, and financial services laws.²³ The IMF also provided technical assistance for the organization, accounting, financial reporting, internal auditing, and an appropriate central bank facility.²⁴ The IMF also based their support on Western standards.

The third organization that provided support was the United States Agency for International Development (USAID). They focused on four main areas within the financial sector: central bank oversight, retail banking, small and medium enterprise finance, and microfinance. USAID also provided advice on how to implement on-site examinations of commercial banks using trend analysis and methods to bring the accounting system in line with internationally recognized standards. To develop retail banking and small and medium enterprise finance, USAID assisted in the enactment of financial laws and regulations. To facilitate growth of small and medium enterprises, USAID supported the bank's ability to provide loans to these enterprises. As part of microfinance, USAID programs also provided capital and technical

²² Messrs. A. Bennett (ed.), B. de Schaetzen, R. van Rooden, Dicks-Mireaux, F. Fischer, and T. Kalfon, *Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth* (Washington, DC: International Monetary Fund, September 2003), <http://www.imf.org/external/pubs/ft/scr/2003/cr03299.pdf> (accessed 14 August 2011), 8.

²³ International Monetary Fund, *Country Report No. 02/219, Islamic Republic of Afghanistan: Report on Recent Economic Developments and Prospects, and the Role of the Fund in the in the Reconstruction Process* (Washington, DC: International Monetary Fund, October 2002), <http://www.imf.org/external/pubs/ft/scr/2002/cr02219.pdf> (accessed 10 February 2011), 39.

²⁴ Staff of the Monetary and Financial Systems Department, *Background Paper for MFD Technical Assistance to Recent Post-conflict Countries* (Washington, DC: International Monetary Fund, 13 December 2004), www.imf.org/external/np/ta/2005/eng/022805.htm (accessed 14 August 2011), 5.

assistance in order to facilitate the banking system and to develop *Shari'a* compliant loans and transactions.²⁵

With assistance from the World Bank, IMF, and USAID, the government of the Islamic Republic of Afghanistan enacted the DAB Law of 2003. By implementing this law, Afghanistan created an autonomous central bank for Afghanistan.²⁶ Its tasks, as formulated in Article 2 of DAB Law, are in line with the five internationally recognized standards for a proper functioning central bank. These tasks are control over the local network of banking services or banks, the pursuit of price stability, the facilitation of a stable system of payments, the ability to provide independent economic advice to the government, and the capability to ensure that commercial banks have sufficient financial funds to meet their obligations. According to USAID, DAB accounting and reporting in 2009 and 2010 remains consistent with International Financial Reporting Standards, as prescribed by the International Accounting Standards Board. Therefore, DAB formally fulfills the international recognized standards for a central bank and achieves objective confidence.

Bank penetration and subjective confidence in the financial system in Afghanistan and its region is inadequate. According to the Enterprise Analysis Unit of the World Bank, only 3.4 percent of the firms have a line of credit with a financial institution compared to 8.6 percent in Pakistan and 10.5 percent in Uzbekistan. Among all firms in Afghanistan, 91.6 percent use internal means to finance working capital. In Pakistan, Tajikistan and Uzbekistan it is

²⁵ United States Agency for International Development, *Fact Sheet Afghanistan* (Washington, DC: USAID, June 2010), <http://afghanistan.usaid.gov/documents/document/document/1004> (accessed 14 August 2011).

²⁶ Da Afghanistan Bank, "The Afghanistan Bank Law," *The Official Gazette*, (17 December 2003), http://www.centralbank.gov.af/pdf/UpdatedOfDaAfghanistan_BankLaw_1_.pdf (accessed 13 August 2011), 1–2.

respectively 86.3 percent, 90.0 percent, and 94.4 percent. Only 1 percent of the Afghan firms use banks to finance working capital, against 1.6 percent in Pakistan, 1.3 percent in Tajikistan, and 3.6 percent in Uzbekistan. If a firm in Afghanistan needs a loan, collateral requirements equal 254 percent of the loan. That is almost twice the average percentage of Tajikistan. Finally, 36.6 percent of the businesses identify access to finance as a major constraint, while the next highest score is only 17.7 in Pakistan (see Table 1). Although the figures show similarities among the four nations, Afghanistan has the lowest level of bank penetration.

	Table 1: Bank Penetration in Afghan Region			
	Afghanistan (2008)	Pakistan (2007)	Tajikistan (2005)	Uzbekistan (2005)
% of firms that have a line of credit with or loans from financial institution	3.4	8.6	-	10.5
% of firms using internal financed working capital	91.6	86.3	90.0	94.4
% of firms using banks to finance working capital	1.0	1.6	1.3	3.6
% of firms using supplier/customer credit to finance working capital	3.7	11.9	5.0	1.0
% of firms using other means to finance working capital	3.7	0.2	3.7	1.0
Value of collateral as % of loan	253.5	67.7	145.2	122.2
% of firms who identify finance as a major constraint	36.6	17.7	4.4	11.6

Source: World Bank, "Enterprise Surveys," <https://www.enterprisesurveys.org/CustomQuery/Indicators.aspx?characteristic=size&indicator=51> (accessed 14 August 2011).

The World Bank described an inadequate level of bank penetration and subjective confidence in the formal financial system of Afghanistan. The local Afghan reports of the DAB describe a different perspective. The DAB confirms in its Strategic Plan 2009–2014 the problem

concerning bank penetration in Afghanistan.²⁷ According to the DAB, there is still a vast number of people, potential entrepreneurs, and small enterprises excluded from the services of the financial system in Afghanistan. Although the DAB does not quantify the problem, the bank confirms that a substantial number of firms are dependent on an informal financial system, like internal ways to finance investments and working capital. This constrains the possibilities for economic growth because capital for expansion is limited.²⁸ The DAB acknowledges the importance of an effective financial system and formulates the objectives in the strategic plan to promote possibilities for savings, access to credit, and the development of the necessary financial institutions.²⁹ The DAB specifically mentions the importance of accountability and transparency of the financial system to give customers, investors, and entrepreneur's confidence in the system.³⁰

Although the World Bank and the Strategic Plan describe the problems concerning bank penetration, the annual financial report 2008–2009 of the DAB describes a slightly different perspective. The total amount of assets of the Afghan banking system increased by 73.4 percent from March 2008 until March 2009. According to the DAB, this is a sign of increased confidence in the Afghan financial system. The total amount of loans increased over the same period by 25

²⁷ Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009*, Kabul, Afghanistan: Da Afghanistan Bank, August 2009, http://www.centralbank.gov.af/pdf/DAB_QB_Annual-1387%282008-2009%29.pdf (accessed 13 September 2011), 93–102.

²⁸ Da Afghanistan Bank, *Strategic Plan 2009–2014, Fostering Price Stability and Building a Robust Financial System*, Kabul, Afghanistan: Da Afghanistan Bank, 22 February 2009, http://www.centralbank.gov.af/pdf/Strategic_Plan_2009-2014.pdf (accessed 13 September 2011), 24.

²⁹ Ibid., 44.

³⁰ Ibid., 22.

percent and the deposits increased by 86 percent.³¹ However, it is not clear whether there is a correlation between the increase of assets, loans, and deposits and increased bank penetration and confidence. First, the return on assets decreased from 1.8 percent to 1.7 percent.³² That means that the financial system was less profitable. Based on efficiency, one would expect an increase in profitability when more people use the formal financial system. Second, the DAB does not provide any insight in the amount of individual accounts. This means that it is not possible to estimate whether more people or firms used the formal financial system. It only shows an increased value of assets, loans, and deposits. Third, half of the deposits are in US Dollars.³³ This means that local currency is still not very popular and could indicate a lack of confidence in the financial system and limited bank penetration.³⁴ It is therefore unlikely that there is an increase in bank penetration and confidence in the Afghan financial system.

Afghanistan received considerable support from very capable financial and development organizations to develop its financial system. However, all three organizations used Western principles to support the development of the Afghan financial system. This support led to objective confidence in the financial system, because the financial system fulfilled the internationally recognized financial standards. However, the support did not secure subjective confidence. Based on data of the World Bank and the DAB, it is justified to conclude that bank penetration and subjective confidence is still extremely low.

³¹ Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009*, 93–8.

³² Ibid., 93.

³³ Ibid., 98.

³⁴ Crane et al., “Guidebook for supporting Economic Development,” 77.

***Shari'a* Compliant Finance**

Muslims claim SCF is a valuable alternative to conventional banking.³⁵ Although the literature mentions the Igibi Bank of Babylon in 575 BC as one of the first Islamic banks, the modern Islamic banking sector is a rather young industry.³⁶ Modern Islamic finance has existed since 1970.³⁷ In addition, the first all-embracing Islamic bank was the Dubai Islamic Bank, established in 1975.³⁸ Since then, the Islamic financial sector has grown enormously. According to a report by Standard and Poor's, Islamic bank assets increased from \$639 billion in 2008 to \$822 billion in 2009, a total increase of 28.6 percent.³⁹ Despite the Islamic claims and the growth of the industry, it is not clear what Islamic finance encompasses. Therefore, this section defines SCF – its sources, principles, products, and standards – to create an understanding of the concepts of SCF. This will enable the reader to understand the latter parts in this monograph.

Definition of SCF

There is no precise definition of SCF. Therefore, this monograph will delineate its own definition and starts with a short literature review of SCF definitions. Defining SCF as interest

³⁵ Hans Visser, *Islamic Finance: Principles and Practice* (Cheltenham, UK: Edward Elgar Publishing Limited, 2009), ix.

³⁶ Muhammad Ayub, *Understanding Islamic Finance* (West Sussex, UK: John Wiley & Sons, 2007), 179.

³⁷ Shayerah Ilias, "Islamic Finance: Overview and Policy Concerns," *CRS Report for Congress* (9 February 2009), http://assets.opencrs.com/rpts/RS22932_20090209.pdf (accessed 23 August 2011).

³⁸ Visser, *Islamic Finance*, ix.

³⁹ Paul Coughlin, "Islamic Finance Outlook 2010," *Report for Standard & Poor's* (19 April 2011), http://www2.standardandpoors.com/spf/pdf/media/Islamic_Finance_Outlook_2010.pdf (accessed 23 August 2011), 9.

free banking is an example of a narrow definition, while describing SCF as a financial operation conducted by Muslims is too broad.⁴⁰ However, there are definitions that are more concise. The first defines SCF as a financial system based on the principles of the *Quran*.⁴¹ Although not very detailed, this definition creates a distinction between a conventional or Western financial system and SCF. Other scholars define SCF as “a system that adheres strictly to the rulings of *Shari’a* in the fields of finance and other dealings.”⁴² This definition expands it to issues other than financial products. A more comprehensive definition of SCF is:

A non-interest based financial institution, which complies fully with Islamic laws and has creative and progressive financial engineering to offer efficient and competitive banking, investment, trade finance, commercial, and real estate financing services.⁴³

This definition encompasses not only the application of Islamic laws but also refers to non-interest based finance as a basic principle of SCF. By mentioning progressive financial engineering, the definition seems to recognize the essential balance between the conformity with Islam and the financial needs of Muslims. A final example of a definition of SCF is a financial system that executes finance in consonance with the ethos of Islam and which is governed by *Shari’a* principles.⁴⁴ This definition perfectly describes the intent of SCF.

⁴⁰ Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006), 2.

⁴¹ Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press, 2000), 5.

⁴² Mehboob ul Hassan, “People’s Perceptions towards the Islamic Banking: A Fieldwork Study on Bank Account Holders’ Behaviour in Pakistan,” *Oikonomika* 43, no. 3 (April 2007), http://www.econ.na.goia-cu.ac.jp/~oikono/oikono/vol47_34/pdf/vol43_34/09_hassan.pdf (accessed 25 August 2011), 153–176.

⁴³ Abdul Qawi Othman and Lynn Owen, “Adopting and measuring customer Service Quality (SQ) in Islamic Banks: A case study in Kuwait Finance House,” *International Journal of Islamic Financial Services* 3 (2001), <http://www.iiibf.org/journals/journal9/abdulqawi.pdf> (accessed 23 August 2011), 1–26.

⁴⁴ Muhammad Shehzad Moin, “Performance of Islamic Banking and Conventional Banking in Pakistan: A Comparative Study,” *Master Degree Project in Finance Advance Level, University of Skövde*

This monograph defines SCF as a financial system based on Islamic principles and values that offers Muslims a possibility to fulfill their financial needs within the limits of Islam. For further clarification of this definition, values are the beliefs people have about what is right and wrong, what is most important in life, and which control their behavior.⁴⁵ The following sections describe the sources, principles, and products of SCF in order to put this definition into perspective.

Sources of SCF

The basis of Islam is that the individual obeys the rules of *Shari'a* because the individual has an agreement or contract with Allah. The rules describe unity and oneness on earth as well as in the hereafter. By obeying the rules, men establish social unity and cohesion. According to the Islam, all conduct contrary to *Shari'a* leads to disunity and disintegration. Final judgment before Allah is as an individual as well as a part of the collective.⁴⁶ Therefore, there is an individual as well as a collective motivation to adhere to the rules of *Shari'a*. Although Islam has primary and secondary sources, there are also some major differences between the implementation of Islam because of different schools of thought, movements, and regional customs.

Islamic law has three primary sources and three secondary sources. A pyramid is an allegory for the primary and secondary sources. The first primary source, at the top of the

(Spring Term 2008) <http://his.diva-portal.org/smash/record.jsf?pid=diva2:113713> (accessed 25 August 2011), 8.

⁴⁵ Elizabeth Walter ed., *Cambridge Advanced Learner's Dictionary* (Cambridge, UK: University Press, 2008), 753.

⁴⁶ Zamir Iqbal, and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*. (Singapore, Asia: John Wiley & Sons Pte Ltd, 2007), 5–6.

pyramid, is the *Quran*. According to Muslims, this is the Holy Book, the word of God as conveyed to the Prophet Mohammed.⁴⁷ The second layer from the top consists of the *Hadith* and the *Sunna*, both primary sources. The *Hadith* are short texts and refer to the words and deeds of the Prophet Mohammed.⁴⁸ The *Sunna* explains and analyzes the *Quran* as well as the *Hadith* and consists of the practices and rulings deduced from the *Quran* and the *Hadith*.⁴⁹ The third layer of the pyramid consists of secondary sources. These sources are *Ijtihad*, *Ijma*, and *Qiyas*. *Ijtihad* refers to the activities of legal scholars to find solutions for emerging problems in a society where the *Quran*, the *Hadith*, and *Sunna* do not provide a solution. *Ijma* and *Qiyas* are the ways legal scholars exercise *Ijtihad*.⁵⁰ *Ijma* refers to problem solving by consensus. Muslims believe that consensus by a group of legal scholars in a certain society prevents men from failures to make the right decisions. *Qiyas* provides solutions by analogy or logical inference when the other sources such as the *Quran*, the *Hadith*, *Sunna*, and *Ijma* do not provide a workable solution for a problem. The legal scholars try to determine how the Prophet Mohammed would have acted in a specific case.⁵¹

⁴⁷ Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000), 32.

⁴⁸ Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006), 27–8.

⁴⁹ Warde, *Islamic Finance in the Global Economy*, 32.

⁵⁰ Iqbal and Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, 13–4.

⁵¹ Warde, *Islamic Finance in the Global Economy*, 32.

SCF Principles

According to Islamic law, Allah created the universe and controls it. To control life on earth, Allah delegated stewardship to men. However, *Allah* also realized that humans are not without faults. Therefore, Allah provided rules and guidance to men in every part of their life. Because of the contract between Allah and men, men must obey these rules even when these rules go against their personal interests, because adhering to the rules is in the public's interest. Applying the rules brings unity and social cohesion because they take the welfare and well-being of others specifically into account.⁵²

The pursuit of unity, cohesion, and the well-being of others is also visible in the four main SCF principles. The first principle is the ban on *Riba*, an amount of money that a borrower must pay to a lender for the use of money and for which the rate is determined beforehand. Islam considers *Riba* as a form of excess. According to some Muslim scientists, the Quran forbids *Riba* because it enslaves the debtor.⁵³ Other scientists argue that the *Quran* only forbids excessive *Riba*. The *Quran* only forbids charging interest when it brings injustice.⁵⁴ The reality is that most Muslims feel uncomfortable when charging or receiving interest. Secondly, money is not an asset in its own right; it is a means to exchange goods. Tangible assets must always back money.⁵⁵ This

⁵² Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (The Hague, NL: Kluwer Law International, 2002), 10–11.

⁵³ Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism*, 3rd ed. (Princeton, NJ: Princeton University Press, 2006), 40–1.

⁵⁴ Imad-ad-Dean Ahmad, "Riba and Interest: Definitions and Implications," *Minaret of Freedom Institute Preprint Series* 96-5, Minaret of Freedom Institute, Bethesda (15–17 October 1993), www.minaret.org/riba.htm (accessed 25 August 2011).

⁵⁵ Kabir M. Hassan, and Mervyn K. Lewis, *Development of Islamic Economic and Social Thought; Handbook of Islamic Banking*, (Cheltenham, UK and Northampton, MA, USA: Edward Elgar, 2007), 34.

prevents the growth of debt and, therefore, social injustice. The third principle is the avoidance of *Gharar*, failure to disclose information needed to make a decision. The avoidance of *Gharar* means that people must avoid every uncertainty or ambiguity when they trade.⁵⁶ The fourth principle, *Haram*, refers to investments that should enhance society. The *Quran* prohibits consuming goods or services such as alcohol, pornography, gambling, and products made of pork.⁵⁷ All these principles promote the social unity and cohesion within Islamic societies.

SCF Products

To pursue social unity, cohesion, and the well-being of others, SCF created some very specific SCF products. The SCF products of *Mudarabah*, *Musharaka*, and *Murabaha* are not the only SCF products but they are the most common. These SCF products also show how previously mentioned principles work in SCF. *Mudarabah* and *Musharaka* are two profit-and-loss sharing (PLS) products. *Murabaha* is an example of how banks can offer financial products despite the ban on *Riba* (interest). *Mudarabah* is a financial construction based on profit sharing. Within this construction, the bank provides money and the borrower or, more specifically, the entrepreneur does the work. The bank and the entrepreneur share the profit based on a pre-determined ratio. The profit sharing continues as long as there is a debt. When the entrepreneur has repaid the debt, the profit sharing ceases. In the event that the entrepreneur goes bankrupt, the bank shoulders the costs. No one compensates the bank for its losses.⁵⁸ *Musharaka* is similar, although, in this

⁵⁶ Iqbal and Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, 53.

⁵⁷ Usmani, *An Introduction to Islamic Finance*, 27.

⁵⁸ Linda Eagle, "Banking on Shari'a Principles: Islamic Banking and the Financial Industry," The Edcomm Group Banker's Academy, New York, NY (14 May 2009), http://www.anythingislamicbanking.com/articles/article_2010_002.html (accessed 25 August 2011).

construction, the bank as well as the entrepreneur shares the losses in proportion to their investment of finances and work. The bank and the entrepreneur determine the ratio in advance. *Musharaka* is an example of PLS.⁵⁹ *Murabaha* is an example how to deal with the ban on Riba in SCF. *Murabaha* is a financial construction in which the bank buys goods and services for the borrower. In this way, the bank does not officially lend money to the borrower; the bank makes a profit on the investment by marking up the prices of the goods or services. Therefore, the borrower has to repay more than the initial costs of the bank's purchase.⁶⁰

Standards of SCF

Three main organizations set the standards and safeguard *Shari'a* character of SCF. The first organization is the Islamic Financial Services Board (IFSB). In 2002, the IMF assisted in founding the IFSB. Its task is supervision and regulation of SCF. Its goal is to complement the work of the Basel Committee on Bank Supervision, which is the organization that sets the standards for internationally recognized banking standards.⁶¹ The second organization is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This organization focuses on accounting, auditing, solvency, and the application of *Shari'a*. The AAOIFI issues certifications for SCF institutions and has a *Shari'a* board that tries to unify all the

⁵⁹ Muhammad Shaukat Malik, Ali Malik, and Waqas Mustafa, "Controversies that make Islamic Banking Controversial: An Analysis of Issues and Challenges," *American Journal of Social and Management Science* 2, no. 1 (2011): 42.

⁶⁰ Eagle, http://www.anythingislamicbanking.com/articles/article_2010_002.html.

⁶¹ Visser, *Islamic Finance*, 97.

rulings of the individual *Shari'a* boards.⁶² The AAOIFI and IFSB are overarching organizations that concentrate on setting the standards for SCF. However, banks do not universally apply those standards and the organizations have no power to enforce the standards.⁶³ The third organization is the *Shari'a* Supervisory Board (SSB) of each individual bank. These boards consist of at least three Islamic scholars who direct, review, and supervise the activities of the Islamic financial institution in order to ensure *Shari'a* compliance.⁶⁴ These boards can issue *Fatwas* to declare financial products are *Shari'a* compliant.

This subsection described the way in which SCF conducts business within the SCF principles and manages the ban on *Riba*. This subsection also described the way in which the Islamic financial system ensures *Shari'a* compliance within the financial system. The SCF products are logical from an Islamic perspective and fit the SCF principles. This does not automatically mean that SCF also improves bank penetration. The following subsection will therefore describe how, according to Islamic literature, SCF can improve bank penetration.

Islamic Proposed Ways to Facilitate Bank Penetration

The function of a financial system is to reduce the risk for investors and to create financial possibilities for entrepreneurs, regardless of whether the financial system is based on

⁶² Ron Terrell, "Islamic Banking: Financing Terrorism or Meeting Economic Demand?" Naval Postgraduate School, 2007, http://edoc.bibliothek.uni-halle.de/servlets/MCRFileNodeServlet/HALCoRe_derivate_00003456/Islamic_banking_financing.pdf (accessed 16 August 2011), 65.

⁶³ Visser, *Islamic Finance*, 95–6.

⁶⁴ Hassan and Lewis, *Handbook of Islamic Banking*, 136.

religious principles.⁶⁵ This subsection describes the possible ways for SCF to facilitate bank penetration in order to bring investors and entrepreneurs together within the financial system.⁶⁶ According to the literature, SCF has at least four positive ways to facilitate bank penetration. First, SCF establishes just and equitable distribution of resources. Second, SCF fulfills the specific financial needs of Muslims. Third, SCF is more reliable compared to conventional financial systems. Finally, SCF development depends, for its development, less on a well-functioning rule of law than a conventional financial system.

SCF focuses on just and equitable distribution of resources. The primary focus of SCF is not profit maximization but to enable Muslims to conduct financial transactions in adherence to *Shari'a*.⁶⁷ SCF is a welfare system, which focuses on economic development in order to facilitate societal benefits such as just and equitable distribution of resources. The evidence for this statement is the use of PLS and the ban on *Riba* instead of focus on profit maximization like conventional financial systems.⁶⁸ A study conducted in Pakistan confirms the welfare aspect of SCF and its contributions to economic development for society as a whole. The research also found that SCF contributes to a higher level of customer satisfaction because of these effects.

⁶⁵ International Finance Cooperation of The World Bank Group, *Afghanistan Country Profile 2008* (Danvers, MA: The World Bank Group, 2008), [http://www. enterprisesurveys.org/documents/EnterpriseSurveys/Reports/Afghanistan-2009.pdf](http://www.enterprisesurveys.org/documents/EnterpriseSurveys/Reports/Afghanistan-2009.pdf) (accessed 14 August 2012), 11.

⁶⁶ Bank penetration is the percentage of firms or people in a specific area that use banks or other financial institutions to fulfill financial services.

⁶⁷ Ashfaq Ahmad, Asad Afzal Humayoun, and Uzair ul Hassan, "An Analysis of Functions Performed by Islamic Bank: A Case of Pakistan," *European Journal of Social Sciences* 17, no. 1 (October 2010), http://www.eurojournals.com/ejss_17_1.htm (accessed 12 September 2011), 8.

⁶⁸ Ibid.

Therefore, an increased satisfaction of customers contributes to a higher bank penetration.⁶⁹

According to the United States Institute of Peace, this means that SCF should be more tolerant of low-income customers and should be prepared to take more risks to provide these customers the financial assets they need.⁷⁰ By applying SCF, Islam creates cohesion and social unity as described in the *Quran*. According to Muslims Islam is a comprehensive and all-encompassing system that focuses on sustainable, ethical, and socially responsible behavior on earth as well as in the hereafter.⁷¹

SCF fulfills the specific financial needs of Muslims. The fact that financial institutions offer SCF can increase bank penetration for Muslims. There will always be Muslims who do not want to participate in a financial system, which is not *Shari'a* compliant.⁷² The application of SCF for religious reasons can be that single, important incentive to attract Muslims to the formal financial system in a country.⁷³ The government of Turkey provided an example when they used

⁶⁹ Ashfaq Ahmad, Kashif ur Rehman, and Muhammad Iqbal Saif, M. I., "Islamic Banking Experience of Pakistan: Comparison of Islamic and Conventional Banks," *International Journal of Business and Management* 5, no. 2 (2010), 141.

⁷⁰ Andrew Cunningham, "Are Islamic Banks a More Powerful Force for Post-Conflict Economic Development than Conventional Banks?" United States Institute of Peace, *International Network for Economics and Conflict Blog*, entry posted May 2, 2011, <http://inec.usip.org/blog/2011/may/02/are-islamic-banks-more-powerful-force-post-conflict-economic-development-convention> (accessed 12 September 2011).

⁷¹ Konrad Adenauer Stiftung E.V., "Islamic Economic Thought and the Social Market Economy," *Im Plenum Kompakt* (September-October 2010), http://www.kas.de/wf/doc/kas_21925-544-2-30.pdf?110216095211 (accessed 10 August 2011), 4.

⁷² Islamic Financial Services Industry Development, "Ten Year Framework And Strategies," Islamic Development Bank, Islamic Research And Training Institute, Islamic Financial Services Board, 2007, http://www.ibisonline.net/En/Policy_Dialogue/TenYearFrameworkAndStrategies.pdf (accessed 6 August 2011), 19.

⁷³ Omer Demir, Mustafa Acar, and Metin Toprak, "Anatolian Tigers or Islamic Capital: Prospects and Challenges," *Middle Eastern Studies* 40, no. 6 (2004): 171.

SCF in 1983 to attract people to the formal financial system.⁷⁴ Although Turkey focused on taming the effects on political Islamists, it shows that emotion can be a reason to use a formal banking system even in a secular state like Turkey. To offer SCF in order to attract Muslims to the formal financial system and increase bank penetration seems even more important in non-secular societies. Afghanistan is an example of a non-secular state. The Director General of the Financial Supervision Department of the Afghan Central Bank, Da Afghanistan Bank (DAB) iterates that the most important reason for Afghans not to participate in the formal banking system is that the financial system is not *Shari'a* compliant.⁷⁵ Applying SCF can increase bank penetration among Muslims and therefore improve economic development. The application of SCF can therefore enhance accessibility in a larger area and for a larger group of people that would normally exclude themselves, from a formal non-*Shari'a* compliant financial system.

SCF is more reliable compared to conventional banking for three reasons. The first reason is that SCF is based on PLS. As mentioned previously, the function of the financial system is to reduce risk for investors and to create financial possibilities for entrepreneurs.⁷⁶ PLS means that a depositor of money shares in the profit as well as in the losses of the financial institution. Therefore, the financial institution is not the only one that runs the risk when investing money. A SCF institution has less risk for insolvency and can be more reliable than a conventional financial institution.⁷⁷ A prerequisite for the depositor is that he has access to information to make a

⁷⁴ Ji-Hyang Jang, "Taming Political Islamists by Islamic Capital: The Passions and the Interests in Turkish Islamic Society," *PhD dissertation*, The University of Texas at Austin (2005), www.lib.utexas.edu/etd/d/2005/jangj05548/jangj05548.pdf, (accessed 12 September 2011), 141.

⁷⁵ Pasha, "Afghan Central Bank sees Islamic Banking Law Enacted in 2011."

⁷⁶ International Finance Cooperation of The World Bank Group, *Afghanistan Country Profile*.

⁷⁷ Visser, *Islamic Finance*, 135.

SCF depends less on a well-functioning rule of law than a conventional financial system. Research conducted in low-income countries, stated that there is a positive correlation between presence of rule of law and development of financial institutions. The rule of law protects the rights of people and therefore limits the costs of doing business. The availability of rule of law therefore enhances the efficiency of the financial system.⁸⁴ However, other research found that Islamic banks depend less on the quality of institutions that facilitate rule of law.⁸⁵ It highlights a different influence of the rule of law on Islamic banks. The main reason for the limited dependency on rule of law is the strict application of *Shari'a* law. This prevents people's dependence solely on the formal judicial system to protect their rights. Muslim scholars or clerks settle disputes.⁸⁶ Therefore, Islamic banks do not depend as much as conventional financial institutions on the availability of a well-functioning rule of law. This should have a positive influence on the level of bank penetration in developing countries where rule of law is often lacking or insufficient.

Application of SCF in Afghanistan

So far, this monograph has described the current effectiveness of the Afghan financial system. The analysis of the development of the Afghan financial system showed that the World Bank, IMF and USAID mainly applied Western financial principles and neglected SCF as an

⁸⁴ Enrica Detragiache, Poonam Gupta, and Theirry Tressel, "Finance in Lower-Income Countries: An Empirical Exploration," *Working Paper* 05/167, Washington, DC: International Monetary Fund, August 2005, http://www.econdse.org/faculty/poonam/papers/Finance_21.pdf (accessed 10 September 2011), 21.

⁸⁵ Patrick Imam, and Kangni Kpodar, "Islamic Banking: How has it Diffused?" International Monetary Fund, 2010, <http://www.imf.org/external/pubs/ft/wp/2010/wp10195.pdf> (accessed 16 August 2011), 16.

⁸⁶ *Ibid.*, 20.

alternative or complementary system to facilitate bank penetration. The literature provided examples of the positive effects of SCF to facilitate bank penetration. The current section focuses on the effectiveness of the application of SCF for the specific situation in Afghanistan. The question is whether the application of SCF could have improved bank penetration in Afghanistan.

The first subsection analyzes whether the application of SCF would attract enough Muslims to make a difference in facilitating bank penetration. Because SCF is inseparably linked to *Shari'a*, the second subsection analyzes the reasons for Muslims to select SCF. The third subsection analyzes whether SCF is reliable in order to increase bank penetration in Afghanistan. The fourth subsection will do the same for sustainability. The fifth subsection analyzes whether applying SCF will actually improve the development of the financial system because SCF depends less on conventional financial institutions as on the availability of a well-functioning rule of law. This section will end with a conclusion.

Quantitative Preference for SCF

According to Islamic law, applying Islamic rules brings unity and social cohesion because it creates welfare and well-being for others.⁸⁷ This implies that there should be a relatively large number of Muslims who prefer SCF over a conventional financial system in order to adhere to the contract between Allah and men. Therefore, religious reasons should be one of the most important reasons to choose SCF. This subsection analyzes the percentage of Muslims that choose to use SCF to fulfill their financial needs.

The monograph uses the results of the analysis to determine the percentage of Muslims in Afghanistan that would prefer SCF because there is no specific data for Afghanistan. In addition,

⁸⁷ Usmani, *An Introduction to Islamic Finance*, 10–11.

every research has its own focus. It is also difficult to exclude external factors that influence the choice of Muslims who prefer SCF. These external factors can be poverty, availability of infrastructure, knowledge of SCF, or differences between secular and non-secular societies.

To estimate the potential size of the group of Muslims that prefers SCF in Afghanistan, this subsection uses research conducted in Central Java and Yogyakarta, as part of the Republic of Indonesia, Syrian Arab Republic (Syria), West Bank and Gaza Strip as part of the Palestinian territories, Pakistan, and Yemen. In order to extrapolate the results to Afghanistan, all countries have a similar percentage of Muslims in their population as Afghanistan. The percentage of Muslims ranges between 92 percent in Syria and 99.7 percent in Afghanistan.⁸⁸

Research conducted by The Indonesia Bank and the University of Semarang in 2000 in Central Java and Yogyakarta showed that 48.3 percent of the Muslim population would choose SCF because they perceived interest as forbidden within Islamic Law.⁸⁹ In July 2008, the World Bank conducted a microfinance market assessment in Syria and found that 43.2 percent of the population only wanted to use SCF because they perceived conventional banking as incompatible with Islamic law.⁹⁰ It is difficult to determine how the lack of knowledge of financial services

⁸⁸ Pew Research Center's Forum on Religion & Public Life, "Mapping the Global Muslim Population," *Report on the Size and Distribution of the World's Muslim Population* (October 2009), <http://pewforum.org/newassets/images/reports/Muslimpopulation/Muslimpopulation.pdf> (accessed 28 September 2011), 28–33.

⁸⁹ Bank of Indonesia and Research Center on Development Studies Research Institute Diponegoro University Semarang, "Research on Potency, Preference and Society Behavior Toward Syariah Banking System in Central Java and Yogyakarta Provinces," *Executive Summary* (2000), <http://www.bi.go.id/NR/rdonlyres/4DFA2814-DAF4-4CFC-8D5B-109018D30895/13298/BPSESJatengenglish.pdf> (accessed 28 September 2011), 21.

⁹⁰ Grameen-Jameel Pan-Arab Microfinance Limited and the International Finance Corporation, "Syria: Microfinance Market Assessment," *Final Report* (July 2008), <http://ebookbrowse.com/syria-microfinance-market-assessment-final-posted-cgap-july2008-pdf-d45320007> (accessed 29 September 2011), 46.

influences choice, because research also pointed out that 20.9 percent were not aware of the possibilities to acquire loans from a formal financial system like a bank.⁹¹ In May 2007, the World Bank conducted a survey on the West Bank and in Gaza Strip.⁹² Research showed that 55 percent of the entrepreneurs on the West Bank and 61 percent in Gaza Strip would choose SCF if they had had a choice.⁹³ In 2010, research in Pakistan found that 52.6 percent of the population preferred SCF as their way to fulfill financial services. At the same time awareness of different SCF products ranged from 13.5 percent to 66.7 percent.⁹⁴ The conclusion was that SCF has an enormous potential for further development. However, SCF institutions have to improve awareness among their customers.⁹⁵ Research conducted in Yemen estimated that 40 percent of the population in Yemen preferred SCF, even if it were more expensive than conventional financial services.⁹⁶ However, the expectation is that, based on research in Syria and Pakistan, awareness of SCF among the population of Yemen is relatively low.

Based on the aforementioned research (see Table 2), between 40 and 61 percent of the population of the countries surveyed prefer SCF if they have a choice. It is therefore reasonable to

⁹¹ Ibid.

⁹² The International Finance Corporation (IFC) and Palestinian Network for Small and Microfinance (PNSMF), "Microfinance Market Survey in the West Bank and the Gaza Strip" (May 2007), <http://www.microfinancegateway.org/gm/document-1.9.26182/MicrofinanceMarketSurvey-Final.pdf> (accessed 29 September 2011), 3.

⁹³ Ibid., 10.

⁹⁴ Naveed Azeem Khattak and Kashif-Ur-Rehman, "Customer Satisfaction and Awareness of Islamic Banking System in Pakistan," *African Journal of Business Management* 4, no. 5 (May 2010): 667.

⁹⁵ Ibid., 670.

⁹⁶ Karim, Tarazi, and Reille, "Islamic Microfinance: An Emerging Market Niche," 5.

conclude that, based on extrapolation, at least 50 percent of the Muslims in Afghanistan should have a strong preference for SCF. At the same time, research pointed out that awareness of SCF products is in some cases low. Therefore, the percentage of a preference for SCF can increase when financial institutions inform people about the possibilities of SCF.

When 50 percent of the people prefer SCF, it is reasonable to conclude that a substantial part of the population chooses SCF. In addition, this percentage could be even higher if the population has enough knowledge and information about SCF to make a choice. However, the percentage of Muslims choosing SCF does not give any insight into the actual reasons for choosing SCF. The next subsection will analyze whether religion is an important selection criterion or whether there are other reasons to choose SCF.

Table 2: Quantitative Preference for SCF						
	Java	Syria	West Bank	Gaza Strip	Pakistan	Yemen
Percentage of Muslims preferring SCF	48.3	43.2	55	61	52.6	40

Source: See footnotes in the text.

Qualitative Preference for SCF

It is also important to know why Muslims choose SCF. As explained earlier, Islamic literature links the characteristics of SCF to Islam and states that it promotes unity and social cohesion; SCF fulfills the needs of the people and, therefore, facilitates bank penetration. This subsection analyzes the reasons why Muslims choose SCF. The analysis uses international research conducted in Kuwait, Libya, Jordan, Bangladesh, Malaysia, and Pakistan.

The most frequently mentioned reason in the literature to choose SCF is the fact that the conventional financial system is un-Islamic because of the application of interest. This refers to the ban on *Riba* as explained in this monograph.⁹⁷ The reference to the ban on interest is a misperception because the statement neglects the interpretation possibilities within SCF as conducted by the SSB of each individual bank. If the SSB does not interpret the interest as excessive, they can issue a fatwa to declare a financial product *Shari'a* compliant. Although it is not a broad interpretation of *Shari'a*, it is a legitimate interpretation.⁹⁸

Local circumstances can differ and each research has its own focus. However, there are some similarities for the reasons why Muslims choose SCF. Research in Kuwait found that reliability of the financial institutions and the diversity of services were the most important reasons to choose a financial institution. SCF principles and products were only fifth on the list of the selection criteria. The research also stated that the population of Kuwait is multi-bank users. They use the financial institution that best fulfills their needs. Religion is not an important selection criterion in Kuwait.⁹⁹ It is important to mention that Kuwait deviates from the rest of the countries because the average income of Kuwaitis is considerably higher.

A survey conducted in 2007 and 2008 in Libya showed that the most important reason to choose SCF was that entrepreneurs perceived more encouragement for business expansion and the willingness of SCF institutions to share risk with them. Interest free banking provided less

⁹⁷ See page 9–11 of this monograph.

⁹⁸ Ahmad, "Riba and Interest: Definitions and Implications."

⁹⁹ Thabet A., Edris, "Services Considered Important to Business Customer and Determinants of Bank Selection in Kuwait: A Segmentation Analysis," *International Journal of Bank Marketing* 15, no. 4 (1997): 126-133.

motivation for Libyan entrepreneurs.¹⁰⁰ This research indicates an opposite effect compared to the Kuwait research. It also seems to indicate that perception of SCF is more important than facts. Not statistical evidence, but personal opinions of the entrepreneurs were the most important source of the research.

Research conducted in Jordan found four main reasons for choosing SCF. The first reason was the profitability of the bank. Although this can refer to PLS between banks and depositors, it can also refer to reliability and sustainability. The research does not clarify this issue. The second reason was the influence of friends and relatives. The third reason was religion and the fourth reason was the image and reputation of the financial institution.¹⁰¹ It is not clear whether the fourth reason refers to the marketing image of a financial institution, the religious image, or the reliability and sustainability of the institution. The research also does not prioritize the reasons, but there is more emphasis on religion and social aspects such as peer influence.¹⁰²

Research in Bangladesh found three main reasons why people in Bangladesh choose SCF. The first and most important reason was that the bank follows the SCF principles as described in this monograph. The second reason was that a bank should be at a convenient location for the customer. The third reason was the influence of family and friends.¹⁰³ This

¹⁰⁰ Alsadek H.Gait, and Andrew C. Worthington, "Libyan Business Firm Attitudes Towards Islamic Methods of Finance," Griffith Business School, Griffith University, 2009, http://www.griffith.edu.au/_data/assets/pdf_file/0009/146871/2009-10-libyan-business-firm-attitudes-towards-islamic-methods-in-finance.pdf (accessed 10 August 2011), 8.

¹⁰¹ Ahasanul Haque, Jamil Osman, and Ahmad Zaki Hj Ismail, "Factor Influences Selection of Islamic Banking: A Study on Malaysian Customer Preferences," *American Journal of Applied Sciences* 6, no. 5 (2009): 924.

¹⁰² Ibid.

¹⁰³ Mohammad Saif Noman Khan, M. Kabir Hassan, and Abdullah Ibneyy Shahid, "Banking Behavior of Islamic Bank Customers in Bangladesh," *Journal of Islamic Economics, Banking and Finance* 3, no. 2 (July–December 2007): 190.

research provides a similar perspective as the research conducted in Jordan. Religion is an important reason and family and friends influence others when choosing a financial institution.

A study conducted in Pakistan in 2010 analyzed bank customers' behavior. Research found four main reasons why people chose SCF. The first reason was adherence to Islamic principles. The second reason was the influence of family and friends. The third reason was the profitability of the bank and the last reason was easy access to the bank.¹⁰⁴ This research supports the results in Jordan and Bangladesh. Religion and the adherence to the Islamic principles are the most important reasons to choose SCF. The next important reason is the influence of family and friends. Profitability is the third, and convenience last.

The studies show that most of the arguments are based on subjective confidence of Muslims in the SCF system, because facts are hardly mentioned or taken into consideration to determine the preferences. The studies also confirm the importance of religion and social influences in the way in which Muslims choose their financial institution. Because most of the studies focused on perception and not on facts, the results show the importance of subjective confidence that people have in a system. Religion and social influence are important factors for selection. Because only SCF can provide financial services in accordance with *Shari'a*, SCF is an important way to fulfill the needs of Muslims. This knowledge creates opportunities to attract Muslims towards the formal financial system in Afghanistan.

¹⁰⁴ Syed Umar Farooq, "A Profile Analysis of the Customers of Islamic Banking in Peshawar, Pukhtunkhwa," *International Journal of Business and Management* 5, no. 11 (November 2010): 116.

Reliability of SCF

Reliability of SCF is the perception of people to trust SCF because the system behaves and works in the way people expect it to behave.¹⁰⁵ Perception facilitates subjective confidence. Reliability has a major influence on the success of SCF. An example is the success of the *Hawala* system, a system based on honor and trust. In the absence of a formal financial system, money exchange dealers provide a well-organized, reliable, convenient, safe, and cost-effective means of making international and domestic payments.¹⁰⁶ Because the Afghans lacked a formal banking system for a very long time, they relied solely on this informal system for their financial needs.¹⁰⁷

In the first place, reliability is primarily a subjective value judgment of the financial system, based on an individual's thoughts and observations. Reliability judgment is therefore closely linked to the two previous subsections. When at least 50 percent of the Muslims prefer SCF, and religious reasons and peer influence are the most important reasons to select SCF, it is an indicator that Muslims perceive SCF as reliable. It does not mean that bankruptcy of the Kabul Bank because of corruption did not damage trust in the financial system in Afghanistan.¹⁰⁸ However, bankruptcy and corruption are not restricted to Islam.

¹⁰⁵ Walter, *Cambridge Advanced Learner's Dictionary*, 1201.

¹⁰⁶ Samuel Munzele Maimbo, "The Money Exchange Dealers of Kabul: A Study of the Hawala System in Afghanistan," Finance and Private Sector Unit, South Asia Region, World Bank (June 2003), [http://www.ifc.org/ifcext/gfm.nsf/AttachmentsByTitle/Tool6.13.WorldBankReport-HawalaSystem/\\$FILE/Tool+6.13.+World+Bank+Report+-+Hawala+System.pdf](http://www.ifc.org/ifcext/gfm.nsf/AttachmentsByTitle/Tool6.13.WorldBankReport-HawalaSystem/$FILE/Tool+6.13.+World+Bank+Report+-+Hawala+System.pdf) (accessed 30 September 2011), 5.

¹⁰⁷ *Ibid.*, 12.

¹⁰⁸ Steven A. Zyck, "Special Report on Economic Development in Afghanistan The Kabul Bank Crisis: What Happened and What It Means for Development, Governance and Security in Afghanistan." Civil Military Fusion Centre, September 2010, https://www.cimicweb.org/Documents/CFCAFGEconomicStabilization_Archive/Econ_Dev_Monthly_Rpt_Sep2010_Kabul_Bank_Crisis_FINAL.pdf (accessed 30 September 2011), 2–4. The Kabul bank went bankrupt because of corruption and fraud.

The second reason why Afghans perceive SCF as reliable refers to the growing demand for SCF.¹⁰⁹ Although this is an implied conclusion, growing demand implies the perception that the system will act and behave as customers expect. The DAB, as well as the Afghan government, recognized this trend, enacted an Islamic Banking Law in 2010, and prepared the financial system to offer SCF. In addition, the reliability of SCF is stronger in non-secular societies because of the tight link between state, society, and religion.¹¹⁰ Research also found that smaller firms with less business experience, smaller assets and employees, fewer owners, and less outstanding debts, are more willing to use SCF to fulfill their financial needs.¹¹¹

The factor that could constrain reliability is the existence of the SSB.¹¹² Because each financial institution has its own religious board, there is no uniformity in its financial products and control mechanisms.¹¹³ Because the interpretation of *Shari'a* differs, it increases uncertainty and therefore decreases the reliability of SCF products and control mechanisms at the macro level.¹¹⁴ Sometimes financial institutions do not even accept each other's SCF products. This could further constrain objective confidence because the financial institutions do not completely fulfill the internationally recognized standards for banks anymore. At the same time, a SSB can

¹⁰⁹ Mohamed Abdel Hamied Hassan El Biesi, "Foreign Banking, Financial Development and Economic Growth: Recent Evidence from MENA Region," Università Degli Studi di Roma "Tor Vergata," 2010, http://dspace.uniroma2.it/dspace/bitstream/2108/1345/1/El+Biesi_PhD_thesis.pdf (accessed 16 August 2011), 18.

¹¹⁰ Pasha, "Afghan Central Bank sees Islamic Banking Law Enacted in 2011."

¹¹¹ Gait and Worthington, "Libyan Business Firm Attitudes," 8.

¹¹² Hassan and Lewis, *Handbook of Islamic Banking*, 136.

¹¹³ Nazima Ellahi, Tayyab Alam Bukhari, and Mehwish Naeem, "Role of Islamic Modes of Financing for Growth of SME's: a Case Study of Islamabad City," *International Journal of Academic Research* 2, no. 6 (November 2010, part I): 165.

¹¹⁴ Visser, *Islamic Finance*, 79.

increase reliability. Especially in Afghanistan, where the formal financial system was destroyed, a *Fatwa* of the SSB can persuade people to participate in SCF and strengthen bank penetration. Therefore, SCF can transform a disadvantage into an advantage in Afghanistan.

To conclude, reliability is an expression of subjective confidence and is important for increasing bank penetration. The experience with the *Hawala* system, the growing demand for SCF, the religious nature of Afghan society, and the smaller firms that require finance and feel attracted to SCF all support the conclusion that applying SCF will increase subjective confidence and therefore will increase bank penetration, although the influence of the different Islamic interpretations could constrain reliability. The question whether this also restricts the sustainability of SCF in Afghanistan will be the subject of the next subsection.

Sustainability of SCF

Sustainability of SCF in Afghanistan is the ability to continue the system over a longer period of time.¹¹⁵ To estimate the sustainability of an Afghan SCF system, this subsection describes the Afghan consequences for the application of PLS and asset backed finances. This subsection also describes the specific challenges in Afghanistan that constrain the sustainability of an SCF system.

PLS requires a fine balance of risk between the lender and the financial institution. However, when SCF applies PLS in a strict Islamic manner, borrowers are only interested in PLS when the risk of the enterprise is high because that creates the need to mitigate the negative financial effects of risk. If the borrower has a positive expectation, the conventional financial

¹¹⁵ Walter, *Cambridge Advanced Learner's Dictionary*, 1201-1471.

system that has fixed interest rates is more profitable for the borrower.¹¹⁶ This requires exchange of information among borrower, financial institution, and lender in order to prevent *Gharar*.¹¹⁷ The lender can only estimate risk and willingness to invest when information is available to conduct the financial analysis. Although PLS can have its positive effects, in the specific case of Afghanistan it is difficult to exchange information. First, because information exchange is not part of the normal procedures of smaller firms and they lack the knowledge how to exchange information. Second, Afghanistan lacks the infrastructure in the remote areas to exchange information in a timely and organized manner. As a result, there is risk-sharing but dismal information exchange.

Asset backed finance is problematic during a stability operation, but especially in Afghanistan because people simply lack the assets to back up their loans. This negates the positive effects of asset-backed finance as explained earlier in this monograph, but also increases the risk for financial institutions and lenders. This is one of the reasons why the collateral for loans is 253.5 percent as depicted in Table 1.

The challenges to apply PLS and asset-backed finance are reasons that the SCF system creates financial products that are *Shari'a* compliant in form, but are less *Shari'a* compliant in content. An example is when a depositor participates in a PLS construction and the bank provides the depositor a fixed return on investment instead of a return based on the profit of the activities of the entrepreneur. Banks sometimes do this to compete with conventional banks that provide a fixed interest rate. The bank provides a product that is *Shari'a* compliant in form but not in

¹¹⁶ Visser, *Islamic Finance*, 81.

¹¹⁷ *Gharar* is the failure to disclose information needed to make a decision.

content by defining the return on investment as compensation and not as interest. This is a method of financial engineering that mimics conventional financial products without violating the formal SCF regulations like *Riba*.¹¹⁸ The SSB of each financial institution determines whether a financial product fulfills the requirements of SCF.¹¹⁹ It all depends on how to define the return on investment. Although the literature mentions this as a disadvantage of SCF, it is a practical solution for the Afghans to apply SCF. Therefore, the best compromise is to engineer financial products in such a way that they fulfill the SCF religious requirements and fulfill the required financial function and balance of risk.¹²⁰

The challenges to sustain a SCF system in Afghanistan are a consequence of infrastructure that years of war destroyed and continuity of insecurity. Therefore, financial institutions will have to invest in security as well as in infrastructure to enable them to develop their financial system outside the major cities. The current financial system is highly centralized and 75 percent of all loans arise in Kabul.¹²¹ Therefore, providing financial services is expensive outside Kabul because population density is low, infrastructure is poor, and loans are small.¹²² In addition, Afghanistan lacks qualified professionals that have knowledge of *Shari'a*, finance, and

¹¹⁸ Visser, *Islamic Finance*, 145–6.

¹¹⁹ Hassan and Lewis, *Handbook of Islamic Banking*, 136.

¹²⁰ Malik, Malik, and Mustafa, *American Journal of Social and Management Science* 2, no. 1 (2011): 44.

¹²¹ U.S. Department of State, “Overview of Foreign Investment Climate,” March 2011, <http://www.state.gov/e/eeb/rls/othr/ics/2011/157228.htm> (accessed 30 September 2011).

¹²² Maliha Hamid Hussein, “State of Microfinance in Afghanistan,” Institute of Microfinance (InM), 2009, <http://inm.org.bd/saarc/document/Afghanistan.pdf> (accessed 10 August 2011), 26.

economics. This means that financial institutions have additional expenses to hire expensive expatriate staff that has the capabilities and knowledge needed to operate the financial system.¹²³

To conclude, the best compromise between religion and functionality is to create a SCF system that establishes legitimacy based on religion, but uses conventional finance to be functional. This means that financial engineering within SCF is not a negative characteristic, but a practical compromise to facilitate bank penetration and develop economic growth in Afghanistan.

Rule of Law

As previously described, SCF depends less on conventional levels of rule of law because of the strict application of *Shari'a* law. Therefore, people do not depend on the conventional judicial system but adhere to the verdicts of Islamic scholars and clerks to settle disputes.¹²⁴ Additionally, the long-term positive results of the Hawala system in areas where there was no formal rule of law implies that SCF can survive and grow under such circumstances. However, depending on *Shari'a* for the implementation of SCF has both short term and long-term effects.

The short-term effect is positive for bank penetration and the economic development of an Islamic region. Using the Islamic system will facilitate bank penetration because it gives people the possibility to protect their property rights, which is a prerequisite for business. Properties rights are important, especially in low-income countries. Effective property rights limit uncertainty and makes doing business more efficient and less expensive.¹²⁵ However, depending

¹²³ Malik, Malik, and Mustafa, *American Journal of Social and Management Science* 2, no. 1 (2011): 43.

¹²⁴ Imam and Kpodar, "Islamic Banking: How Has it Diffused," 20.

¹²⁵ Enrica Detragiache, Poonam Gupta, and Theiry Tressel, "Finance in Lower-Income Countries: An Empirical Exploration," Working Paper 05/167, (Washington, DC: International Monetary Fund,

on local justice will decrease uniform rights in Afghanistan because the interpretation of *Shari'a* differs per region or school of thought. Nevertheless, it will facilitate subjective confidence in the regions.

The long-term effect is that it will be extremely difficult to create a uniform Afghan financial system that adheres to the international recognized standards for finance because interpretation and application of rules and regulations will differ per region. However, the IMF can prevent this problem by continuing and intensifying its support and cooperation with the IFSB to supervise and regulate SCF in Afghanistan. This should not be difficult because the IMF is already supporting the IFSB.¹²⁶

Applying SCF can facilitate Afghan bank penetration because it does not need the same level of rule of law as a conventional financial system. Therefore, subjective confidence in the SCF system will increase. The only long-term point of concern is that there should be a plan for evolving into a system that adheres to the internationally recognized standards of finance and, therefore, establishing objective confidence.

Bank Penetration

The application of SCF can facilitate bank penetration in Afghanistan by improving subjective confidence without having to violate objective confidence. Currently, bank penetration is low in Afghanistan. The international development community missed an opportunity to attract at least 50 percent of the Muslims in Afghanistan to the formal financial system by making the

August 2005), http://www.econdse.org/faculty/poonam/papers/Finance_21.pdf (accessed 14 December 2010), 1.

¹²⁶ Visser, *Islamic Finance: Principles and Practice*, 97.

population aware of SCF. By developing a financial system that based on a Western financial paradigm, the Western organizations neglected the preferences of the local population as well as the possibilities of SCF to facilitate bank penetration.

The analysis also found that religion and social influences are the most important reasons why people choose SCF as the preferred way to fulfill financial needs. Although most of the studies focused on perception and not on facts, the results indicate the importance of subjective confidence that people have in a financial system. In addition, the fact that Afghanistan is relatively poor and has an Islamic society helps to attract people to SCF and, therefore, facilitates bank penetration in Afghanistan.

Literature implies financial engineering as a negative characteristic of SCF. However, the analysis in this monograph found that financial engineering could be a practical solution for the situation in Afghanistan. Establishing legitimacy based on religion and using conventional finance creates a functional system that fulfills profitability and, therefore, sustainability. SCF is a way to establish a practical compromise to facilitate bank penetration and develop economic growth in Afghanistan.

Applying SCF can facilitate Afghan bank penetration because it uses local Islamic judicial systems to settle disputes and protect property rights. The effect is also that it facilitates subjective confidence in SCF. SCF is local and people are familiar with the system. The only point of concern is that in the longer term Afghanistan needs a plan of how to evolve into a system that adheres to the internationally recognized standards of finance to establish objective confidence.

Significance for the Military Commander

Operational art promotes unified action and supports the commander in achieving the strategic objective by integrating the elements of national power as well as the efforts of multinational partners. Operational art is commander centric and enables the commander to link

the ends, ways, and means in order to achieve the desired military end state.¹²⁷ Therefore, the commander designs an operational approach that describes the broad actions the force must achieve.¹²⁸ To develop an operational approach the commander must understand the strategic direction and the operational environment, and the commander must define the problem.¹²⁹ As stated in the introduction of this monograph, military forces play an important role in supporting economic stabilization and infrastructure development and the support for the development of a financial system.¹³⁰ However, besides some security and logistical tasks, there is no evidence that the military provided any substantial support for the development of the financial system in Afghanistan.¹³¹ Previous discussion showed that SCF could facilitate bank penetration by improving subjective confidence without compromising on objective confidence in order to develop the financial system as part of the economic development of Afghanistan. This section describes five lessons the military commander at the operational level can learn from this knowledge to assist in achieving the military end state.

¹²⁷ Joint Staff, *Joint Publication 5-0, Joint Operation Planning* (Washington, DC: Joint Chiefs of Staff, 11 August 2011), III-1.

¹²⁸ *Ibid.*, III-5.

¹²⁹ *Ibid.*, III-7.

¹³⁰ U.S. Army, *Field Manual 3-07, Stability Operations* (Washington, DC: Headquarters, Department of the Army, October 2008), 3-14–6.

¹³¹ Staff of the Monetary and Financial Systems Department, *Background Paper for MFD*, 5.

Lessons Learned

The first lesson is that this monograph found that SCF is an alternative or at least a valuable complement to the development of a financial system in Afghanistan. Commanders should consider this when planning, preparing, executing, and assessing a stability operation in a country with a Muslim majority. This leads to four addition lessons.

The second lesson is that the commander should challenge and compare the Western definition of the operational environment, the problem and the operational approach with a Muslim paradigm. Although the military commander is in a supporting role when developing a financial system, commanders should realize that a Western paradigm could hinder their analysis of the operational environment and development of an operational approach. Previous subsections have shown that the social, economic, and financial elements of the operational environments in Afghanistan are different from a Western environment. For example, Muslims focus more on the hereafter than non-Muslims do, Muslims consider just and equitable distribution of resources as important functions of their economic system, and Muslims cannot invest in *Haram* goods and services. Although previous subsections showed that the function of a financial system is to reduce the risk for investors and to create financial possibilities for entrepreneurs, regardless of whether the financial system is based on religious principles, the operational approach supporting SCF system can be different from supporting a Western financial system.¹³² Different paradigms will influence the perspective of an operational environment and the operational approach achieving the military end state. Challenging our Western paradigm prevents the military commander from pursuing the wrong military tasks in time, space and purpose.

¹³² International Finance Cooperation of The World Bank Group, *Afghanistan Country Profile* 2008.

The third lesson is that the military must invest in basic knowledge of Islam, SCF, and Afghan society in order to effectively support the development of a financial system in Afghanistan. This goes further than cultural awareness. The monograph described the sources, principles, products, and standards of SCF, and described positive Islamic ways to facilitate bank penetration. The previous sections showed that Islam and the SCF system are different from our Western, primarily Christian, society and financial system. These differences require that the military obtain additional knowledge in order to prepare, plan, execute, and assess the support of an SCF system during stability operations in Afghanistan. This knowledge enables the military commander to mitigate weaknesses and threats; it also enables the commander to use the strengths and opportunities of the SCF system. An example is the use of religious reasoning and social influences to increase subjective confidence in the SCF system in order to facilitate bank penetration. A conventional Western approach would probably have focused on rationale, to convince the population. Previous subsections showed that Muslims have different considerations deciding which financial system to choose.

The fourth lesson is that the military should start building partnerships with other organizations that could facilitate the development of a financial system. The military can build partnerships with interagency organizations such as USAID. USAID has considerable experience in providing microfinance in Afghanistan. Additionally, USAID not only provides financial and local Afghan information, but also can integrate and synchronize its activities as an interagency organization with the military. An example is USAID providing microfinance based on SCF principles, standards, and products to local entrepreneurs and integrating the Commander's Emergency Response Program Funds into SCF. This also means spending the funds in accordance with SCF principles.

A second group with whom to build a partnership is an international organization such as the IMF. The IMF has a wealth of expertise and experience. The military could use this

information to improve its own effectiveness. An example of cooperation with the IMF is the use of knowledge they have in regard to their support of the IFSB.

A third group with whom to build partnerships are the local Islamic scholars and clerks. Local scholars and clerks can support the military commander's understanding of the operational environment and provide information to develop an operational approach. Their knowledge can provide insight into local circumstances because, as described earlier, Islam is not a monolith. SCF can differ per region, per school of thought, or even because of different local interpretation. Previous subsections also showed the importance of religious arguments in building subjective confidence. Local scholars and clerks can facilitate the improvement of subjective confidence in the SCF system because they can explain and convince the local Muslim population by using religious reasoning that fits local circumstances.

The fifth and final lesson is that the military commander should focus on facilitating local efforts instead of providing a solution for the development of the local financial system. The World Bank, the IMF, and USAID provided mainly top-down support to the financial system. However, religious arguments and social influences are the most important reasons to choose SCF. Facilitating local Muslim efforts better supports subjective confidence than providing them a Western based system. A bottom-up approach seems to be more promising compared to previous efforts by the World Bank, IMF and USAID. Although there are some shortcomings in SCF principles, products and standards, SCF is able to attract a substantial percentage of Muslims to the formal financial system. Therefore, during preparing, planning, executing and assessing a stability operation, the military commander should not only focus on the disadvantages of SCF, but also on how to combine the positive effects of SCF with conventional finance in order to achieve a maximum development effect on the financial system. Examples of this combination are the SCF products that are Islamic in form and conventional in content. The military commander should not judge a financial product when it fulfills the needs of Muslims and fits into the international financial system. Another example is to enable the local population to use

Shari'a to develop their financial system or to settle their disputes, especially in Afghanistan, where the informal *Hawala* system replaced a destroyed financial system. Bank penetration can benefit from SCF.

Summary

SCF can facilitate bank penetration in order to develop the financial system in Afghanistan. However, using SCF provides the military commander five lessons. The first lesson is that SCF is an alternative or at least a valuable complement for the development of a financial system in Afghanistan. The second lesson is that the military commander must challenge and compare the Western paradigm with a Muslim paradigm in order to prevent to develop a deficient operational approach. The third lesson is that the military has to invest in basic knowledge of the Afghan society, Islam, and SCF in order to mitigate weaknesses and threats and to use the strengths and opportunities of the SCF system. The fourth lesson is that the military should start building partnerships with other organizations to enable unified action. The final lesson is that the military commander should focus on facilitating local efforts instead of providing a solution for the development of the financial system in order to achieve the maximum development results.

Conclusion

This monograph challenged the generally accepted way of developing the financial system in Afghanistan. SCF improves the development of a financial system during stability operations by increasing subjective confidence in the financial system and therefore increasing bank penetration in Afghanistan.

Development of the Afghan financial system focused on Western financial principles and neglected SCF to facilitate the development of the financial system. As a result, the World Bank, IMF and USAID, as main contributors, established the internationally recognized standards for a financial system in Afghanistan. However, based on World Bank and DAB data, bank penetration

was inadequate. These organizations managed to achieve objective confidence, but failed to establish subjective confidence in the financial system in Afghanistan.

The second part of the monograph defined SCF as a financial system based on Islamic principles and values that offers Muslims a possibility to fulfill their financial needs within the limits of Islam. This part also described the sources, principles, products and standards of SCF which research used to analyze whether SCF could have been an alternative for the development of the financial system in Afghanistan. Based on the assessment of the available information, research found that an estimated 50 percent of the Afghan population would choose SCF if they had a choice and that religion and social influence are the most important reasons for SCF selection.

Reliability of SCF is closely linked to subjective confidence: the perception of people to trust SCF because the system behaves and works in the way people expect it to behave. Although research did not find data that could objectively validate the reliability of SCF, the number of Muslims preferring SCF and the growing demand for SCF provided the basis for the conclusion that reliability of SCF is high among Muslims. However, the existence of an SSB could constrain objective confidence while at the same time an SSB can also pursue subjective confidence because they have the legitimacy in a Muslim society to determine financial products as *Shari'a* compliant.

Sustainability of the SCF system is problematic in the Afghan situation, especially when applied a strict manner. It was therefore remarkable to discover that there is some level of adaptability in SCF systems because Muslims do not always apply PLS, asset backed finance, and other SCF products in a strict manner. Financial engineering is a way to fulfill Islamic needs and requirements, while simultaneously establishing sustainable financial products. The best compromise between religion and functionality is to have an SCF system that uses religion to establish legitimacy but uses conventional finance to be functional. Therefore, the disadvantage

of SCF is mitigated by creating SCF products that are *Shari'a* compliant in form but not necessarily in content.

A lack of rule of law is not always problematic for the development of SCF because it uses the local Islamic judicial system of scholars and clerks to settle disputes and protect property rights. Using the local system even facilitates subjective confidence in the financial system. The only point of concern is that in the longer term there Afghanistan needs a plan to evolve into a system that adheres to the internationally recognized standards of finance and therefore establishes objective confidence.

The third part of the monograph described the lessons for a military commander when tasked to support the development of a financial system. Research found five main lessons. The first and foremost lesson is that SCF is an alternative or a valuable complement to a conventional financial system in Afghanistan. The military commander should not limit himself to analyzing and acting only in accordance with a Western paradigm. The force also needs additional knowledge about Islam and local Afghan financial customs. The military should invest in partnerships with interagency, international, and local Afghan organizations and entities such as Islamic scholars and clerks. The last and most important lesson is that the military should facilitate local efforts instead of imposing a solution. When the military supports and encourages locals, they can increase subjective confidence and improve bank penetration.

To conclude, the best way to apply SCF in order to improve the development of a financial system in Afghanistan during stability operations is by facilitating local efforts, which facilitates subjective confidence and therefore increases bank penetration. In order to mitigate the risk for sustainability in the longer term, the World Bank and especially the IMF should maintain their focus on how to evolve an SCF system into a system that is still *Shari'a* compliant but also fulfills all internationally recognized financial standards. This is not a major challenge because the IMF is already engaged in providing support to the IFSB, and maybe this is a first step to enable the local population to truly own their economy.

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